Beneath the Surface

October 2023

SIGNET

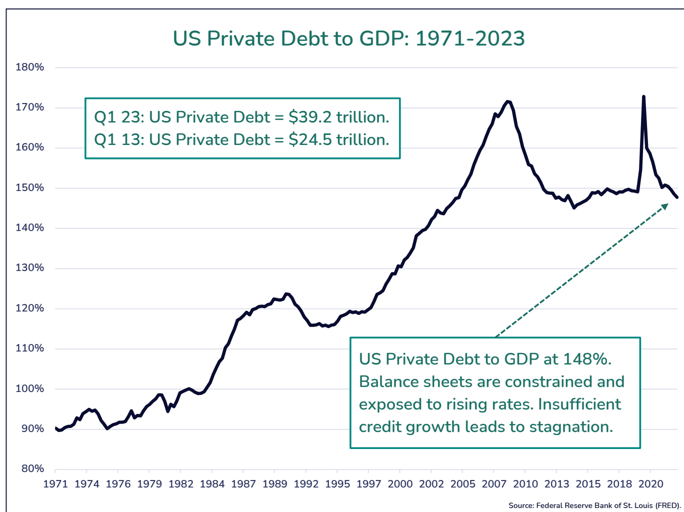
Quick to Borrow, Slow to Pay

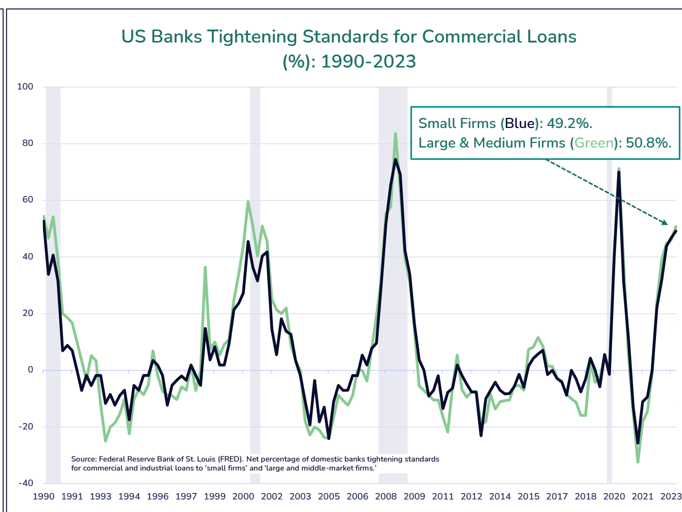
- The global monetary policy tightening cycle is probably over but the impact remains to be seen. Recall, the Fed stopped hiking rates in July 2006 and it was only 18 months later that we saw the ramifications of interest rate policy on the equity markets. The Global Financial Crisis (GFC) was eventually dated by the NBER to start in December 2007. As the post-Covid 'excess' credit runs dry, GDP and inflation might begin to roll over (further) and sentiment may follow. There probably isn't enough evidence of an adverse outcome priced into risky asset classes right now, certainly at the index levels. The cause of financial crises is often found in the growth and elevated state of private debt, rather than in the high level of government debt, which seems to be the current concern of many analysts and policymakers. It is the rapid acceleration of private debt-to-GDP to, and beyond, 150% that can lead to economic fragility and many countries have been at this level since 2005, which has prompted the 'secular stagnation' debate.

- The first chart (left) plots US private debt-to-GDP, which is currently at 148%. Notably, the primary driver of this statistic is currently non-financial corporate debt, up 84% since 2013, rather than household debt, which has risen by only 44% in that time and was the primary driver during the GFC build up. It is notable because the US faces a significant corporate refinancing issue over the next 18 months and the average interest rate on US marketable debt has just risen to its highest level since 2009. At least $2.1 trillion of US corporate debt matures between now and the end of 2025. At a holistic level, total global debt now exceeds $307 trillion, up from $207 trillion in 2013 (source: IIF) and that accumulation of leverage has occurred within an extremely favorable interest rate environment. A loose monetary policy stance over an extended period vastly increases the probability of a financial crisis.

- Understanding the various flows of liquidity within the system is essential when debt levels are excessive and balance sheets are constrained, as refinancing becomes perpetual. Crossborder Capital estimates that debt refinancing surpasses new capital issuance by a ratio of 7 to 1. Refinancing crises can disrupt financial stability, especially when the 'shadow' banking industry has an outsized impact on the markets, which it has had in recent decades. While the Fed has been quick to support the banking sector in 2023 (i.e. the BTFP), it has less transparency of, control over, and ability to support the vast and intertwined 'shadow' banking system. Given the abrupt rise in interest rates, there may be a serious strain within the collateral pools that underpin the global repo markets (short term lending) – the financial economy's 'plumbing' – and within other private markets. In the meantime, there is evidence of a slowdown in the supply of both consumer and corporate credit. The second chart (right) identifies a trend in the standards for commercial bank credit, and it appears to be indicative of tightening liquidity standards.

- Confronted by another liquidity crisis, the central banks may be forced to act quickly. That might translate into yield curve control (however it's dressed up in name) being initiated along with more QE and rate cuts. As we stare into the next stage of the cycle, we see plenty of risks but also several opportunities, which we'll happily discuss with you.





Research Report Disclaimer: This communication and all the information provided is marketing material. The views and opinions contained herein may not necessarily represent views expressed or reflected in other communications and/or strategies of Signet Capital Management Ltd. (the "Company"). Therefore, this material is intended to be for information purposes only and is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Please read our Marketing Communication Disclaimer for further assistance.

Marketing Communication Disclaimer: The content of this material is a marketing communication and does not constitute any form of independent investment advice and/or recommendation and/or research. The material is for general information purposes only (whether or not it states any opinions). Nothing in this material is (or should be considered to be) legal, financial, investment and/or other form of advice and/or recommendation on which reliance should be placed. No opinion given in the material constitutes a recommendation by Signet Capital Management Ltd. (the "Company") or the author that any particular investment, security, transaction or investment strategy is suitable for any specific person. Although the information set out in this marketing communication is obtained from sources believed to be reliable, the Company makes no guarantee as to its accuracy or completeness. All information is indicative and subject to change without notice and may be out of date at any given time. Neither the Company or the author of this material shall be responsible for any loss that you may incur, either directly or indirectly, arising from any investment based on any information contained herein. This material may include charts displaying financial instruments' past performance as well as estimates and forecasts. Any information relating to past performance of an investment does not necessarily guarantee future performance. Please seek independent advice.